Canada-U.S.-Mexico Free Trade Negotiations:

The Rationale And The Investment Dimension

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Introduction and Principal Conclusions

President Bush announced on August 8 that the United States and Mexico have undertaken to negotiate a free trade agreement. This undertaking is much earlier than expected and President Bush will seek Congressional approval for the initiative in September. In order for Canada to be included in the initiative, the Government of Canada must formally request the President to enter into trilateral negotiations.

This note explores some of the factors bearing upon the decision facing Canada. The purpose of this note is basically twofold:

i) to set out arguments relevant to a decision on whether or not to join the U.S.\Mexico trade negotiations;

ii) to provide preliminary material on investment regulations and flows, in the expectation that investment concerns will figure importantly in the negotiations.

The paper is divided in two parts, reflecting the dual purpose described.

The analysis and conclusions of this paper are necessarily preliminary. More work needs to be done on key issues, including the issue of potential trade and investment diversion from Canada in favour of Mexico as a consequence of a North American free trade agreement. The Economic Council of Canada and a number of universities are undertaking indepth research on these issues. Investment Canada has supplementary research underway on the issue of investment diversion.

At this juncture, the following observations appear to be defensible. It is in Canada's interest to participate in trilateral free trade negotiations with the United States and Mexico. This interest is more broadly based than the recognition that the United States and Mexico are committed to proceeding with or without Canada. A North American free trade zone will strengthen Canada's ability to create global corporations and to specialize in knowledge-based industries, both of which are needed to compete more effectively against other major industrialized countries.

While many Canadians may be concerned that extension of the Free Trade Agreement to include Mexico will lead to job losses, the ultimate outcome should be better job and income prospects for all participants to the extended agreement - including Canadians. Whereas a bilateral agreement between Mexico and the United States might result in negative consequences for Canada, there is little reason to believe that a trilateral agreement would yield a zero sum result. On the contrary, productivity gains from greater economies of scale, lower cost inputs, and industry rationalization based on different comparative advantages should enable Canada to better compete in markets in North America, Asia and Europe.

Mexico has the potential to become an important export market for Canada. By the end of the century its population will be close to 100 million. Sweeping economic reforms, notably liberalization of its trade and investment regulations, are propelling Mexico towards the remarkable achievements already experienced by several countries in Southeast Asia. Formulation of a North American Free Trade Agreement will help Mexico adhere to the economic liberalization so long advocated by the advanced industrialized countries - including Canada. The growth of Mexico is an opportunity for Canada, not a threat. It would be against Canada's self-interest to say no to Mexico's inclusion in a North American free trade agreement. It would also be contrary to improved prospects for developing countries throughout Latin America and abroad. The challenge is to negotiate an agreement that builds upon the interests of the three countries concerned.

The prospect of a North American free trade agreement is capturing a lot of interest in Central and South America. Indeed, several Latin American countries have expressed interest in the possibility of an "America's Accord". While it is very premature to speculate on this possibility, it must be acknowledged that a multilateral approach of this sort is much more desirable than the hub and spoke model. The latter would entail a series of bilateral agreements with the United States, with only it having free access to the markets of the participants. It is this danger that Canada - by agreeing at the outset to trilateral negotiations - can help to avoid.

Part I: The Rationale For Canada's Participation In Trade Negotiations With Mexico And The United States

The Objectives To Be Pursued

Arguments for and against participation in trilateral negotiations with Mexico and the United States will be influenced by the objectives of the Government of Canada, and the likelihood of these objectives being shared or accepted by the other two countries. For purposes of discussion, the key objectives are assumed to be:

i) to secure, in a fair and reciprocal manner, assured access by Canadian business interests to the Mexican market;

ii) to extend the FTA to include Mexico in a manner that minimizes the need for bilateral adjustments between Canada and the United States.

It is assumed, therefore, that participation in the negotiations will not entail, to any substantive degree, further liberalization of Canada's trade and investment provisions with the United States. In particular, another round of negotiations is not anticipated to result in further institutional integration of the Canada\U.S. economies.

The Conventional Economic Assessment

The usual approach to assessing a Canada-Mexico-U.S. free trade agreement is based upon an examination of trade and investment flows among the three countries. More particularly, the assessment entails the following:

- the degree of trade and investment between Canada and Mexico; currently, the flows are very modest; less than half of one percent ($600 million) of total Canadian exports are destined for the Mexican market; imports from Mexico account for 1 percent ($1.7 billion) of total Canadian imports; investment flows are even more modest (the stock of Canadian direct investment in Mexico in 1989 was US$361, or 1.5 percent of the total for Mexico); from the perspective of current trade and investment flows between Canada and Mexico, it would appear that extension of the Canada\U.S. free trade agreement to include Mexico would be of only marginal significance;

- the potential for trade diversion favouring Mexico at the expense of Canada; both Mexico and Canada are heavily dependent upon the United States as an export market; in each case roughly three-quarters of Canadian and Mexican exports are destined for the United States; preliminary analysis indicates that trade diversion could be significant in respect to autos & parts and textiles & clothing; however, structural reforms in Mexico will lead to trade diversion whether or not there is a free trade agreement; an agreement per se will have only marginal significance in terms of competition between Canada and Mexico for the U.S. market;

- the potential for trade creation benefitting all three parties to the agreement; Mexico has a population of 85 million, which is expected to rise to 100 million by the end of the century; with the sweeping economic reforms or "Salinastroika", Mexico could well become a NIC with growth prospects similar to Thailand and Indonesia; per capita incomes would rise sharply, as would the demand for imported consumer products and capital goods; nonetheless, in light of Mexico's small economic stature relative to the U.S. and Canadian economies, the potential gains from trade creation in the short to medium term are very limited;

- the potential for long-term investment diversion; a Mexico\U.S. free trade agreement would certainly undermine Canada's current advantage as the sole country having assured and free access to the U.S. market; this development, together with the increasing attractiveness of Mexico resulting from its structural reforms, may cause a significant increase in its share of the world's flow of direct investment; Mexico's investment gains could be at the expense of Canada, although this presumes a zero sum game; both countries could be more attractive to foreign investment as a result of a North American free trade agreement; one business association has indicated that some of its members foresee a shift concerning the location of manufacturing establishments in low-cost countries, from Southeast Asia in favour of Mexico; because of the all-important rules of origin issue, Canada is more likely to benefit from this shift if it is a member of a trilateral agreement rather than simply a participant in paired agreements (i.e., Canada\U.S. and U.S.\Mexico);

- the strategic interests of tracking an initiative involving Canada's major trading partner; defensive considerations would suggest that it is in Canada's interests to be at the bargaining table, even if the outcome is not expected to appreciably affect its trade and investment flows; Canada should endeavour to shape the outcome of the negotiations in a manner that is most favourable to it; in particular, Canada should endeavour to ensure itself access to low-cost inputs and to allow for an appropriate period of adjustment.

Conventional economic analysis, therefore, would suggest endorsement of trilateral negotiations involving Canada, Mexico and the United States. There are, however, reservations that could be raised. There is, for example, legitimate concern about the complementarity between bilateral (or trilateral) and multilateral agreements - particularly the implications for the MTN given their critical stage. GATT negotiations have so far been unable to resolve subsidies and other forms of protectionism involving agriculture. Canada could find its position on agriculture is at odds with both the United States and Mexico, a danger that is less critical in a multilateral context. Also, there is a danger that the United States could try to bend the trilateral negotiations to reopen "unfinished business" with Canada. In respect to investment, this could entail attempts to have Canada drop its screening process, its imposition of performance requirements, and its restrictions concerning the energy and cultural sectors. On the

other hand, there is increasing concern about foreign investment in the U.S., and there are significant geopolitical stakes for the U.S. in its relations with Mexico. These two factors could lead the U.S. to be flexible in negotiations on investment.

While these and other concerns are valid, it must be recognized that Mexico and the United States intend to proceed in defining a free trade accord. Canada, therefore, faces Hobson's choice. Conventional economic analysis may not be fully persuasive, but it is a solid part of the rationale for participation in trilateral negotiations.

Limitations Of Conventional Economic Analysis

The basic problem with sector-by-sector cost analysis or static equilibrium analysis is that the whole theory and application of comparative advantage is overlooked. While Mexico is a very low wage country (the hourly wage in maquiladora operations is about $1.50), it is also a very low productivity country. Unit labour costs in Mexico tend to be high, except in those firms where modern management techniques and modern capital equipment can offset the lack of skills of the labour force.

Mexico's capacity for efficient production is expanding rapidly, but from a small base. Although it has a population of 85 million, its GDP is little more than one-third of Canada's and its per capita income is one-eighth. Mexico's exports to the United States (its main market) expanded at the rate of 7 percent annually between 1984 and 1988, which is a healthy rate but hardly spectacular or trade threatening. Further, it should be noted that U.S. exports to Mexico during this same period expanded at a much faster rate - 18 percent annually. Canada experienced a similar dichotomy between exports and imports from Mexico; in fact, between 1988 and 1989 Canadian exports to Mexico increased by 160 percent while imports from Mexico increased by only 28 percent (albeit from a much larger base).

To grow from its impoverished state to a middle-income state will take Mexico at least a decade and a huge amount of capital investment. It may take several decades before Mexico's labour force is anywhere near being fully and productively employed. During this transition its appetite for imported capital and consumer goods will be insatiable. Indeed, large foreign capital inflows will be required to offset a substantial current account deficit. The Middle East crisis and the approximate $10 a barrel increase in world oil prices has bolstered Mexico's external position - enhancing its ability to import capital and consumer goods. The increase in the oil price, if maintained over a full year, would generate an extra $ 5 billion or more in export earnings for Mexico; this is equivalent to at least a 2.5 percent increase in its GDP.

The transfer of wealth from oil-consuming nations to oil-producing nations underscores a basic lesson of comparative trade theory. No matter how productive a nation (e.g., the United States) or how low-wage a nation (e.g., Mexico), it cannot produce sufficiently to satisfy domestic markets - let alone world markets. As a result of

its structural reforms, outside capital infusions, and improved terms of trade, Mexico's development prospects are excellent. Its penetration of the U.S. market can be expected to increase, displacing Canadian and American products in the process. In turn, however, Mexico will draw much more heavily upon Canadian and American exports - both to sustain the investment boom and to satisfy the pent-up demand of a more affluent Mexican population. Adjustment will be required on the part of both Canada and the United States, but this adjustment may be accommodated - for the most part - by the ongoing process of adjustment, capital renewal and change in the labour force (through exits and entrants). Canada can expect to benefit from increased economies of scale and productivity gains, benefits that are not reflected in conventional economic analysis.

Explaining the Issues

The Canadian worker is highly susceptible to arguments about the loss of jobs following free trade, especially when the new partner is sometimes portrayed as having sub-standard labour conditions. Debate about the Canada\U.S. free trade agreement has illustrated just how nervous many workers are about fundamental changes in economic policy. Debate about a deal with Mexico may be more muted, since it is relatively remote and the links with Canada are limited. Nonetheless, Canadian workers will want to be reassured that their interests are being protected.

It is going to be a challenge to deal with the natural inclination of working Canadians to feel threatened by changes to the trading relationship. There is no easy solution to this problem, for it is easy for the critics of free trade to point out where job losses are most likely (e.g., the auto parts and textile industries). Unfortunately, it is very difficult for economists and industry experts to state, with any degree of confidence, where job opportunities will arise. Since a job in hand is worth (at least) two in the bush, advocates of the negotiations face a tough task of explaining how a free trade accord with a low wage, labour surplus nation would be to Canada's gain. The sector analysis provided by the Economic Council during the Canada\U.S. free trade debate was digested by very few experts. The overall job loss\gain predictions of various organizations, including provincial governments, unions and business organizations, lacked credibility.

Perhaps the best response to the issue of potential job loss is attention to how to strengthen Canada's productivity performance. Productivity will ultimately determine the degree to which Canada benefits from freer trade and the process of globalization. Attention to productivity accentuates structural adjustment, such as measures needed to end the poverty\welfare trap and the high level of unemployment (more properly, the non-accelerating inflation rate of unemployment).

Explanation will be needed to refute the worst scenarios about free trade, but the difficulty with this sort of focus is that it inevitably requires acknowledgement of problem areas. This, in turn, calls for adjustment assistance or outright protection (e.g. treatment of agriculture under the FTA). Resources could be expended on shoring-up or accommodating weak sectors. Since the resources available to government are extremely limited, this could mean resource allocation to weak sectors at the expense of support for industries having strong growth potential. Such a scenario would be counter to sound economic policy, and in any event, would not be warranted given our assessment of the small changes in the short- to medium-term and the overall positive benefits of a trilateral agreement.

The Global Vision

A very different perspective of the Canada\U.S.\Mexico trade negotiations is gained by considering the north\south dichotomy and, more generally, the globalization of world economies. Mexico is obviously a very poor country struggling to overcome a backbreaking external debt situation and a rapidly growing population (approximately 3.5 percent a year). After many years of extensive state intervention and unsuccessful economic policies, including very restrictive policies concerning foreign investment, Mexico has emerged in recent years with a fresh approach to development. It has demonstrated its willingness to implement the tough structural adjustment measures long advocated by the IMF and the World Bank.

The pace of reform in Mexico is astonishing. It has joined the GATT and dramatically liberalized import restrictions and tariffs. Literally hundreds of state-owned enterprises have been privatized or simply closed. The banking system is to be re-privatized and other key sectors, such as telecommunications, airlines and steel, are to be opened up for private sector participation - including foreign investment. Indeed, foreign investment restrictions have largely being replaced - or are in the process of being replaced - by overtures to take advantage of Mexico's low wage, labour surplus situation. The expansion of the maquiladora program (under which U.S. firms are able to establish assembly plants and import components duty free and pay U.S. duties only on the value-added) is one manifestation of this new attitude towards foreign investment. Another manifestation is the proposed U.S.\Mexico free trade agreement, which the Mexican Government believes will lead to greater confidence and hence greater investment in the country.

Mexico's success is vital to the western world, for it signals endorsement of the market-lead, outward-orientation approach to development so long advocated by western economists. The success of Singapore, South Korea, Taiwan, Hong Kong, Thailand, Malaysia and, most prominently, Japan has stood in stark contrast to the stagnation or reversals suffered by socialist or protectionist countries (e.g., Vietnam and the Eastern Bloc generally). While the break-up of the Soviet "empire" has greatly propelled the adoption of market solutions to age-old development problems, there is a great number

of Third World countries in a highly confused state. Unfairly, but with some effect nonetheless, their regressive economic performance is often attributed to unworkable IMF\World Bank prescriptions. Mexico, like Indonesia and a small number of emerging "NICs", is a model of those same prescriptions applied successfully.

Canada, along with the United States and other G7 countries, has a lot at stake in nurturing Mexico's fledgling success. Part of this stake is purely self-interest. Canada's official development assistance, for example, is approximately $2.5 billion annually. Further, extreme poverty in Latin America and elsewhere in the world compounds the refugee problem. Even the drug problem is believed to be linked with north\south income disparities. More compelling than self-interest, however, is the moral obligation to work towards a more just society on a world scale. In this context, the issue of trilateral trade negotiations does not reduce to quantification of Canada's interests in joining Mexico and the United States at the bargaining table. Rather, the issue is whether we should say no to a developing country that is pursuing newly formed market oriented policies - including now a request to join the United States and Canada in a North American free trade agreement. If we do say no bilaterally, utterances by Canada at the multilateral level in support of Third World development may be regarded as little more than lip service.

Yet another aspect of this question is the globalization of world economies and the implications of this for Canada's trade and investment policies. Investment Canada's research report on this subject (The Business Implications of Globalization) noted that there is little option for Canada but to aggressively adapt to the pressures of globalization. This includes acceptance of world competition for domestic and international markets, unencumbered by tariff and non-tariff barriers. While the world trading system is still fractured by imperfections, there can be little doubt that global corporations are rapidly forcing governments to rely on productivity performance rather than protection to ensure quality jobs for their citizens. Intra-corporate trade is vitally important and, as a reflection of this, direct investment abroad is increasingly a complement to trade rather than a substitute. Investment, in fact, is expected to figure importantly in the negotiations between Canada, the United States and Mexico.

Summary To Part I: The Rationale For Canadian Participation

Conventional analysis of Canada's interests in a North American trade accord including Mexico leads to the following conclusion: the impact of an expanded trade agreement would be marginal, but it is nonetheless in Canada's interests to be part of the negotiations given that Mexico and the United States are committed to proceeding. Less conventional analysis and reflection, which goes beyond simple cost comparisons and description of current trade\investment flows, provides a much stronger case for Canada's involvement in trilateral negotiations. Mexico has adopted the economic prescriptions long advocated by western industrialized countries, including Canada. To help ensure the success of these reforms, Canada should - in concert with the United States - be willing to liberalize trade with Mexico. In any case, with or without a bilateral or trilateral trade agreement, Mexico can expect to develop rapidly if its structural reforms are maintained. Its participation in U.S. and Canadian markets will increase, displacing some jobs in the process. At the same time, however, Mexico's import requirements will soar. Canada must be prepared to respond to these export opportunities. A trilateral trade\investment accord would facilitate a positive response.

Part II: Information And Data Relevant To The Investment Dimension

Section A: Investment Data Re Canada, Mexico And The United States

Section B: The Regulation Of Foreign Investment In Mexico

Section A: Investment Data Re Canada, Mexico And The United States

The following identifies and assesses the recent patterns of investment and, to a lesser extent, trade among the three prospective partners of a North American Free Trade Agreement (NAFTA). Section C.1 of this paper explores in detail recent trends in the pattern of foreign direct investment (FDI) in Mexico (based on Mexican government sources). It examines the major sources of FDI in Mexico, the industry composition of this investment, followed by a brief note on the maquiladora or "inbond" industry and its performance. Section C.2 deals with changes in the stock of U.S. direct investment abroad (USDIA) during the 1980s, as well as the magnitude of U.S. capital flows - particularly to Canada and Mexico. This section also examines the allocation of USDIA by industry in Canada and Mexico. Section C.3 concludes with a brief consideration of the potential for investment diversion.

I. Foreign Direct Investment In Mexico

Among developing countries, Mexico has become an increasingly attractive market for foreign investors, in large part due to the progress in relaxation of regulations over the past five years and its proximity to the U.S. market. In introducing the latest regulatory changes to foreign investment, the Mexican government has made it clear that foreign investment is a top priority and is critical for the future growth of the Mexican economy. Among the Latin American countries, Mexico has the second largest amount of foreign direct investment, exceeded only by Brazil. Despite significant growth of FDI in Mexico over the past several years, however, total FDI in the 1980s has constituted less than 10% of total gross fixed investment in the Mexican economy and its share of GDP has been less than 5 percent.

At the outset, it is important to understand the two different methodologies used by Mexican sources for calculating FDI:

- The Bank of Mexico definition of FDI includes four components of annual flows which, when combined, show the net increase in FDI in a given year. These four components include new investment, reinvestment, accounts with parent companies (accounts relating to intercompany debt flows) and, lastly, purchases of foreign companies (via liquidations, disinvestments). The major drawback of this data is the absence of any information to reflect the aggregate FDI flows by country of origin, including any data on the stock or cumulative value of FDI by country of origin.

- The definition of FDI by the National Foreign Investment Commission (NFIC) is based on investments <u>authorized</u> by the Commission. This figure is usually larger than actual flows, both because of timing considerations and because in some cases this investment does not materialize (or is smaller than authorized).

This source has a major advantage as a measure of FDI since, unlike the Bank of Mexico figures, cumulative flows of FDI can be disaggregated by the country of origin. Thus, despite the fact that these statistics on FDI are higher than the actual levels, they nonetheless provide a measure of the trend in FDI by country.

(a) FDI in Mexico by Country of Origin:

Table I.1 presents the cumulative value of FDI in Mexico by country of origin based on the statistics published by the NFIC on approved foreign investment projects. The cumulative value of FDI are computed from the annual inflows of FDI in Mexico as shown in Table I.2. At the end of 1989, the estimated amount of accumulated FDI in Mexico stood at approximately US$26.5 billion.

By country of origin, 95 % of the stock of foreign investment came from 10 countries at the end of 1989:

1) 63% from the U.S.;
2) 6.7% from the U.K.;
3) 5.1% from West Germany;
4) 5.1% from Japan;
5) 4.4% from Switzerland;
6) 3% from France;
7) 2.6% from Spain;
8) 1.4% from Canada;
9) 1.3% from Sweden; and
10) 1% from Netherlands.

The United States continues to be the largest direct investor in Mexico by a decisive margin, but its share has declined from as high as 69% in 1980 to 63% at the end of the decade. In the interim, the U.K. has doubled its stake of FDI in Mexico, surpassing West Germany as the second largest foreign investor in 1988, with a share that jumped to an all time high of 7.3% that year. The respective positions of other foreign investors in Mexico, including Japan, have not changed substantially since the beginning of the 1980s.

On the basis of NFIC statistics, new foreign investment projects authorized by the Commission during 1989 totalled US$2.5, down from US$3.2 billion in 198[1]. Of this

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[1]However, based on a measure of actual investment flows in accordance with the methodology applied by the Bank of Mexico, inflow of FDI decreased from US$2.6 billion in 1988 to US$2.2 billion in 1989. Some US$1.2 billion dollars correspond to new investments, US$365 million to intercompany financing and US$643 million to reinvested profits. In other words, actual flows of

total, 49 percent were authorized by the NFIC and 51 percent through automatic registration. The flow of authorized FDI in 1989 was the highest in the last decade (excluding debt/equity swaps).[2] At the same time, slow economic growth and worldwide recession reduced the dollar earnings of foreign affiliates, which inhibited both reinvestment and equity investment by U.S. firms.

According to available statistics for 1988, almost three quarters of the US$3.2 billion in new investments came from five source countries: the U.S. (39.3%); the U.K. (24.3%); France (4.8%); Japan (4.7%); and West Germany (4.3%). Preliminary estimates covering the first quarter of 1990 indicate that a total of US$982 million in foreign direct investments were authorized by the NFIC; the largest share of those authorized flows came from the U.S.(45%), followed by France (13%), West Germany (11.1%) and Switzerland (7.6%).

At the end of 1989, the authorized amount of accumulated Canadian direct investment in Mexico reached US$361 million, almost a threefold increase from the levels attained at the beginning of the decade (see Table I.1). However, Canada's share of cumulative FDI in Mexico continues to be less that 1.5% and it is the eighth largest source of foreign capital for Mexico. Of the total amount of US$2.5 billion in authorized new foreign investment in Mexico in 1989, Canada accounted for only US$37.4 million or 1.5% of those investment flows.

Since 1985, the total number of companies with foreign direct investment in Mexico increased by about 2000 to reach 8862 enterprises at the end of 1989. The largest representation of foreign multinational companies with direct investment interests in Mexico are from the United States. Table I.3 shows the rankings of some of

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investment represented almost 90% of authorized investments during 1989.

[2] Between May 1986 and October 1987, the Mexican government carried out a highly successful debt/equity swap program which, combined with the government's increasingly favourable attitude toward foreign investment, brought almost US$ 3 billion in new foreign investment commitments to the country. After a suspension of the debt/equity swap program in November 1987 because of its inflationary and subsidy effects, Mexico recently announced the resumption of a scaled-down version of the program in which the only eligible investments will be equity participation in parastate companies up for sale and infrastructure projects approved by the federal government. The new regulations limits swaps to a total of US$ 3.5 billion over the next three-and-a-half years, and will apply to all public debt that was renegotiated by Mexico and its commercial bank creditors last year.

the major foreign enterprises in Mexico in 1987. To date, there are 214 Mexican companies with Canadian capital, of which 154 are minority owned (less than 49%) and the remaining 60 are majority owned. Table I.4 lists some of the major Canadian investors with either minority/majority ownership in Mexican enterprises.

(b) FDI in Mexico by Industry:

At year-end 1989, just over two-thirds of the total stock of US$26 billion of FDI in Mexico was concentrated in the manufacturing sector, predominantly in the maquiladora operations. The next largest sector to attract FDI was services (24.5%), followed by commerce (7.4%), mining (1.5%), and agriculture and fisheries (0.1%). The share of the manufacturing sector in FDI has averaged about 75% since the beginning of the 1980s.

It is anticipated that the reforms introduced to liberalize Mexico's foreign investment regime will lead to significant expansion of investment opportunities for foreign companies in Mexico's tourism sector, thereby increasing the importance of the services sector.

(c) The Maquiladoras:

Within the manufacturing sector, companies that manufacture under the maquiladora program and export their products to the U.S. enjoy significant competitive advantages in labour costs, logistics, transportation, management, and other factors unavailable to non-participating firms. In an effort to expand employment and training opportunities, the Mexican government allows duty free imports of machinery parts, and raw materials for assembly and finishing of products in Mexico for re-exports into the U.S. or other countries. Most components and raw materials used in production are of U.S. origin and are imported ready for processing. After the assembly process is completed in the maquiladora operation, virtually 100% of the finished or semi-finished products are exported to the U.S. under sections 806 and 807 of the U.S. Customs Code. These sections state that U.S. customs duty on goods originally exported from the U.S. will be paid only on the value which has been added by assembly operations, which in this case would be the value-added in Mexico. Duties vary considerably depending on the type of raw material and the type of manufacturing article.

As a result of these incentives by the Mexican government, the maquiladoras have grown rapidly and countries other than the U.S. are now participating. Mexico's restrictions on the level of foreign ownership do not apply to the maquiladora operations. Since 1971, Mexico has allowed 100% ownership of the maquiladora plants, except those in the textiles and apparel sectors, where 49% foreign ownership still remains. Since the inception of the program almost 25 years ago, employment in the maquiladoras as well as the number of maquiladora plants have grown very rapidly. In 1965, the first year of operation, 12 plants were established employing 3,000 people. By

1970, there were 120 maquiladora plants in operation, and by 1980 that number had reached 620. By year-end 1988 there were total of 1490 companies operating under this program employing almost 400,00 workers, or 1% of Mexico's total employment. By area of principal location, 42% of the total maquila plants in 1988 were located in Baja California, and 21% in Chihuahua along the Mexican-U.S. border zone, each accounting for 20% and 40%, respectively, of total employment in the maquiladora operations during that year.

The total value added to the materials for exports from the maquiladoras totalled US$1.6 billion in 1987 and US$2.4 billion in 1988 (see Table I.5). By industry, electronic machinery and equipment and other accessories accounted for about 41% of the value added in 1989, followed by transportation (25.5%), textiles (8.9%), furniture (4.9%), and food (1.3%). In contrast, chemical plants produced less than 1% of the total value added that year. The electrical/electronic and transportation industry employed 40% and 21.4% of the total workers engaged in the maquiladora operations in 1988, roughly in the same proportion as their respective contributions to value added.

About 60% of maquiladoras in operation in 1986 were either wholly or partially owned by foreign affiliates. The bulk of the foreign-owned maquiladoras are affiliates of U.S. companies. In 1986, however, there were 20 Japanese maquiladoras operating in Mexico, all associated with Japanese corporations that already had productions facilities in the U.S.. Of the top ten maquiladoras operating in Tijuana in 1988, four were Japanese, and their plants accounted for 45% of the employment of the top ten. They are mainly engaged in the assembly of consumer electronic products, automotive parts and accessories, semi-conductors, as well as cutting, forming and machine steel. Their participation tends to be understated since they account for only maquiladoras that are free-standing subsidiaries of these corporations, and exclude other maquila forms that serve them, such as "shells" (Mexican-owned and run industrial parks) and "contract operations" (captives or Mexican subcontractors).

Some researchers argue that many third-country maquiladoras, particularly those from Japan, are able to take advantage of Mexico's cheap labour while avoiding U.S. trade sanctions (e.g. voluntary restraint agreements). These analysts argue that third-country maquiladoras, because of the flexibility in determing local content and value-added, are able to gain access to low tariffs.

2. United States Direct Investment Abroad: Canada And Mexico

Table II.1 illustrates the level of USDIA in the 1980s according to principal geographical areas, and, in particular, the relative trend in the USDIA position in Canada and Mexico. At the outset, it is important to note that both the level and growth in USDIA are affected by several factors. First, the value of USDIA, as shown in Table II.1, represents the book value or original purchase price of direct investment assets by U.S. multinationals. These official figures make no allowance for subsequent

capital gains. In view of the historical evolution of USDIA, the values grossly understate the actual market value of many assets, especially since many such investments were undertaken in the post-war era and have matured considerably since that time.

A second caveat in analyzing USDIA concerns the influence of currency translation gains and losses on the level of dollar-denominated USDIA, and as a result, on their relative growth trends. In brief, these gains and losses arise from the conversion of foreign currency denominated investment values into U.S. dollars. Thus, to a certain extent, currency translation losses were behind the slow growth of USDIA between 1980 and 1985 when the U.S. dollar appreciated vis-a-vis other major currencies; by the same token, currency translation gains were behind the resurgence of USDIA from 1986 to 1988, when the dollar depreciated against major world currencies.

(a) United States Direct Investment in Canada (Book Value):

At year-end 1989, USDIA in Canada amounted to roughly US$67 billion, the largest concentration of American direct investment in any host country[3]. However, there has been a significant decline in the Canadian share of worldwide U.S. direct investment assets in the post-war period: In 1950, almost 30% of all USDIA, or one-half of USDIA in the developed economies was held in Canada. Between 1966 to 1980 Canada's share dropped from a third to a fifth of total USDIA, and has averaged around 18.5% since 1986.

In the first half of the 1980s, USDIA growth in Canada stagnated, symptomatic of the slow pace of worldwide USDIA activity during this period. In the early 1980s, U.S. direct investment in Canada was also constrained by the prevailing investment climate which was generally not conducive to attracting American capital. The establishment of the Foreign Investment Review Agency (FIRA) and the National Energy Program was considered by many to have a debilitating impact on the confidence of U.S. and other foreign investors, and resulted in slowing down their direct investment activities in Canada. These programs not only inhibited new direct investment in Canada, but also encouraged sales of existing direct investment assets in the petroleum and mining industry.

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[3] At year-end 1989, the total book value of worldwide USDIA amounted to US$373 billion, up 12% from the previous year. Three-quarters of these assets were located in the developed economies. Europe, with US$176 billion, accounted for almost half these assets, followed by Latin America (including Central America and the Caribbean Islands), and Asia and Pacific with shares of 16.4% and 15%, respectively. Of the US$40 billion jump in USDIA in 1989, almost half of the direct investments went to Europe and another one-fourth was located in Latin America, while Canada accounted for about 11% of that growth.

As Table II.1 indicates, between 1980 to 1985 growth of USDIA in Canada averaged less than one per cent, although its share of total USDIA at the end of 1985 remained virtually unchanged at around 20%. However, the poor growth of USDIA in Canada was generally consistent with very slow growth in worldwide USDIA during this period. In part, the slowdown in worldwide USDIA growth in the 1980s can be attributed to the effects of converting the value of USDIA from local currency into U.S. dollars at a time when the U.S. dollar appreciated against most major currencies[4]. At the same time, slow economic growth and worldwide recession reduced the dollar earnings of foreign affiliates, which inhibited both reinvestment and equity investment by U.S. firms.

In the mid-1980s, the pace of USDIA in Canada began to accelerate after a period of depressed growth. This coincides with the liberalization of the foreign investment regime in Canada when the Investment Canada Act replaced the more restrictive FIRA in 1985. The stock of USDIA in Canada increased from about US$47 billion in 1985 to US$67 billion in 1989, representing an average annual growth of just over 9%. Although the pace of USDIA in Canada during this period was significantly higher than that recorded in the first half of the 1980s, there was a persistent decline in our share of USDIA from 20.4% in 1985 to just under 18% in 1989. During this period, other regions, notably Europe and Latin America, increased their respective holdings of U.S. direct investment assets. In particular, Latin America increased its share of USDIA from 12.3% in 1985 to 16.4% at year-end 1989, led by a remarkable growth which averaged over 21%, compared to 13% in aggregate USDIA.[5]

(b) United States Direct Investment in Canada (Capital Flows):

Table II.2 indicates the annual net direct investment flows from the U.S. to Canada, Mexico and the other principal regions from 1985 to 1990. In this context, it is

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[4] Between 1980 to 1985, the U.S. dollar appreciated by 18% against the Canadian dollar, 44% against the U.K. £ sterling, 62% against the Deutschmark, 113% against the French Franc, and a 123% against the lira.

[5] At year-end 1989, the Bahamas, Bermuda and Panama accounted for US$30 billion or nearly one-half of all USDIA in Latin America (South and Central America and the Caribbean Islands). Almost 85% of U.S. direct investments in these countries were located in banking and finance. USDIA in such offshore banking centres has accelerated since the mid-1980s to a take advantage of the absence of direct local taxes on income or capital gains, few regulatory requirements regarding international capital flows and financial disclosure, and lower reserve requirements for banks. Apart from these offshore banking centres, Brazil and Mexico accounted for over a third of USDIA in Latin America at the end of 1980s.

important to note that growth in the USDIA position occurs primarily in three ways: (1) equity increases through capital infusion by U.S. parent companies in new or existing foreign affiliates; (2) intercompany lending by parent companies to affiliates; and (3) reinvestment of earnings of foreign affiliates. These three elements are included in the measure of net capital flows of USDIA. Any residual between the net change in USDIA position and net capital flows is reconciled by a fourth item, viz, valuation adjustments. These adjustments reflect capital gains and losses arising from nationalizations, sales or liquidations of foreign affiliates, periodic revaluation of assets to reflect current prices for accounting purposes, or loss due to natural disaster.

The last column of Table I.2 indicates that, from 1985 to 1989, the cumulative value of worldwide U.S. direct investment flows amounted to almost US$111 billion. Two-thirds of this amount was destined for the developed economies, with Europe receiving the lion's share of those flows (47%). As a regional bloc, Latin America was the second largest recipient of USDIA outflows following Europe, attracting about 30% of the direct investment flows from the U.S. between 1985 and 1989.

From 1980 to 1989, Canada's share of the cumulative flows stood at US$12 billion or roughly 12% of the aggregate outflows. Reinvested earnings of Canadian affiliates continue to be the major factor behind USDIA growth in Canada. For example, between 1980 and 1988, cumulative reinvested earnings contributed to roughly 90% of the increase in the USDIA position in Canada. These figures reflect the autonomous nature of many Canadian affiliates of U.S. multinationals who are productive enough to generate earnings to finance their expansion from internal sources rather than rely on funds from their parents.

(c) United States Direct Investment Position in Mexico (Book Value):

In the early 1980s, the debt crises and accompanying slowdowns in South and Central America significantly affected the level of USDIA in that region. While debt problems and related austerity programs reduced the rate of investment in all high-debt countries, some countries were more affected than others. Of the three major debtor countries - Mexico, Argentina and Brazil - only Mexico experienced a major decline of U.S. direct investment from 1980 to 1986.

As Table II.1 indicates, the stock of USDIA in Mexico actually fell from about US$6 billion dollar in 1980 to US$ 4.6 billion by year-end 1986, declining at an average annual rate 4.2% during this period. USDIA in Mexico peaked in 1981 at about US$ 7.0 billion, before declining for two consecutive years (not shown in Table II.1). The fall in the USDIA position in Mexico was primarily due to foreign currency transaction losses

arising from the devaluation of the peso against the dollar[6].

In addition, the decline in U.S. direct investment in Mexico in the first half of the 1980s was precipitated by adverse economic conditions (viz., high inflation and high interest rates on external debt, domestic austerity measures, and government-imposed exchange controls to prevent capital flight from the country). Indeed, these conditions were endemic to most Latin American countries during this period. These sluggish economic conditions reduced the earnings of Mexican affiliates, which in turn reduced funds available for reinvestment. At the same time, economic recession in the U.S. also severely hampered the availability of U.S. source funds to finance Mexican affiliate operations.

Since 1986, there has been a resurgence of USDIA in Mexico, in concert with the significant jump in worldwide USDIA and consistent with the new liberalized foreign investment regime. By year-end 1989, the USDIA position in Mexico stood at US$7.1 billion, slightly more than the peak level attained in 1981. However, the Mexican share of global USDIA declined in the interim, from 2.8% in 1980 to about 2% in 1989. In addition, although no data is available from U.S. sources, new U.S. investment in the export-oriented maquiladora in Mexico has been particularly strong in recent times.

(d) Distribution of USDIA by Industry - Canada:

By the end of 1989, the largest proportion of U.S. direct investments in Canada was concentrated in manufacturing (48.4%), followed by the financial sector (including banking, 19%), petroleum (16.3%), "other" industries (8.5%) and wholesale trade (6%). Canada's share of USDIA in petroleum, manufacturing, and the "other" industries at the end of 1989 was higher than the corresponding proportion of total USDIA in those industries. The "other" sectors in USDIA in Canada, composed mainly of natural resource-based industries (agriculture, forestry, fishing, mining, construction and retail trade) accounts for less than 9% of USDIA in Canada. However, from a global perspective, Canada accounts for nearly 35% of all USDIA in this sector, a share which has remained fairly stable in the 1980s. The relative share of resource based industries in aggregate USDIA has declined from about 6% in 1984 to 4.4% in 1989.

The declining position of U.S. direct investment in the Canadian Petroleum industry reflects the cumulative effects of sale of equity interests, both total and partial, in certain Canadian petroleum affiliates that occurred in the early 1980s. They appear to have been partly in response to Canada's energy policies (NEP), which called for an increase in Canadian participation in the industry. The USDIA stake in Canadian

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[6] In 1982, the peso was devalued from 24.5 pesos to the US dollar to 56.4 pesos, a 130% depreciation. In 1983, the peso was devalued by an additional 112% to an exchange rate of 120 pesos to the dollar.

petroleum actually declined from US$11.2 billion in 1984 to US$10.4 billion as a result of the sale by Chevron Corporation (U.S.) of Gulf Oil (Canada) Ltd. to a Canadian company. In the following two years, U.S. direct investments in the petroleum sector in Canada rose marginally, reaching US$12.1 billion in 1987, before falling to their 1989 levels. In 1989, the divestiture of Texaco Canada and its sale to Imperial oil was primarily responsible for net equity inflows of USDIA of US$2.7 billion from the petroleum industry in Canada, and the consequent decline in USDIA position in that industry.

Within Canada's manufacturing sector, USDIA is most heavily concentrated in the "other" manufacturing sector (textile products and apparel, lumber wood, furniture and fixtures, paper and allied products, leather and allied products, etc.), transportation equipment and chemicals. As Table II.3 indicates, with the exception of the transportation sector and "other" manufacturing industries, the share of all other industries in USDIA in Canada's manufacturing sector declined between 1984 and 1989.

Traditionally, the transportation sector, composed mainly of motor vehicle and equipment manufacture, has been the major recipient of USDIA in manufacturing. However, in 1989, the "other" manufacturing sectors received almost 60% of the increase in USDIA in Canada's manufacturing industries, boosting its share from 9% of total USDIA in Canada in 1988 to about 12% the following year.

At year-end 1989, 11.5% of USDIA in Canada was held in transportation and equipment, up from 9.3% in 1984. This also represented a higher proportion than the share of worldwide USDIA tied up in this industry. Most U.S. direct investment in the automotive sector continues to be held by the "Big Three" U.S. auto companies - General Motors, Ford, and Chrysler - which over the years have invested heavily to take advantage of the cross-border free trade in automobiles under the Canada-U.S. Automotive Products Trade Agreement of 1965. Nonetheless, an interesting trend has been emerging in the past few years that shows the rapid decline in the importance of USDIA in this industry in Canada relative to other countries. In 1989, worldwide USDIA in transportation stood at about US$ 24 billion, roughly a third of which was concentrated in Canada. This share has steadily declined from as high as 40% in 1984 to 36% in 1988, before dipping to its present all time low.

The industry share of USDIA in chemicals and allied products in Canada also suffered a decline from 10.2% in 1984 to 9.8% in 1989. More importantly, this decline also resulted in a loss in Canada's market share of global USDIA in this industry. In 1984, Canada accounted for one-quarter of total USDIA in chemicals, but by 1988 that share had dropped to about 18% as other markets raised their stake in USDIA in this industry.

Outside of the manufacturing sector, USDIA growth in Canada has been most notable in the finance, insurance and real estate sector, where the industry share

increased from just over 13% in 1984 to 17.5% in 1989. The growth of USDIA in financial industries in Canada averaged around 14% between 1984 to 1989. However, this expansion was relatively insignificant compared to the explosive growth recorded in worldwide U.S. direct investment in this industry (38%) during the same period. USDIA in the financial sector in Canada is likely to pick up its pace once deregulation of the industry takes place in the foreseeable future.

(e) Distribution of USDIA by Industry - Mexico:

In 1989, the stock of USDIA in Mexico reached just over US$7.1 billion, tying the record-high level set in 1981. The expansion in USDIA in Mexico from 1984 to 1989 has been slower than total USDIA growth (9% vs 12%), but in those years, the pace of USDIA has accelerated in certain sectors of the economy, causing some significant changes in the industrial composition of USDIA in Mexico. At year-end 1989, the overwhelming concentration of USDIA in Mexico continued to be in manufacturing (83%), followed by wholesale trade (6.%). The relative importance of some of the other sectors cannot be determined as statistics on the amount of direct investment in those industries were suppressed for confidential reasons.

Within manufacturing, the bulk of USDIA in Mexico, like Canada, is concentrated in three major industries, namely, chemicals, transportation equipment, and "other" manufacturing. These industries together account for almost two-thirds of all USDIA in Mexico. The most remarkable growth in U.S. direct investment activity has centred around the transportation industry where the level of USDIA stood at US$1.5 billion in 1989, increasing threefold since 1984. The increase in USDIA in the Mexican transportation sector by US$1 billion during this period accounted for 40% of the growth in total USDIA in Mexico during the five year span. The industry experienced an average annual growth of 25% in USDIA between 1984 and 1989, which almost doubled its share of industrial-USDIA in Mexico from 11% to 21.5% during this period. Mexico's chemical sector also attracts over 20% of USDIA and has experienced strong growth since the mid- 1980s.

In recent times, much of U.S. direct investment in Mexico's transport industry, like other sectors, has been primarily motivated by the significant cost advantages in Mexico's maquiladora region . The "Big Three" U.S. auto producers were among the top five of the five hundred largest enterprises in Mexico in 1987, with 100% U.S.-ownership in the Mexican affiliates (see Table I.3). These auto manufacturers have taken advantage of the maquiladora rules which allow for auto equipment part and components to be imported into Mexico free of duty and re-exported back after assembly into the U.S. with duty being levied on the value added in assembly in Mexico and any component not of U.S. origin.

3. Summary

The preceding is but a first step in the analysis of the investment implications of a Canada-U.S.-Mexico free trade deal. Further research on issues such as investment creation/diversion in the context of a NAFTA is required. It should be noted, however, that investment diversion under a bilateral U.S.-Mexico accord would likely be more significant than under a trilateral arrangement.

In sum, the U.S. is the predominant source of foreign capital for both Canada and Mexico. At present, bilateral investment between Canada and Mexico is of marginal significance, each accounting for less than 2% of total foreign direct investment in their respective economies. The U.S. continues to hold the largest share of the outward stock of global direct investment, and Canada is still the largest host to worldwide U.S. direct investment assets. Canada accounts for roughly one-fifth of U.S. direct investment abroad, while the U.S. accounts for about two-thirds of all FDI in Mexico.

Many factors need to be taken into account in an assessment of the potential gain or loss to Canada in terms of investment creation and diversion. Significant changes in the pattern of global investment flows have occurred in the past few decades, and such changes in foreign direct investment flows may continue, irrespective of whether Canada joins a NAFTA. For example, while the U.S. remains the dominant source of foreign investment in Canada, other countries (notably the U.K., Japan and West Germany) have significantly increased their share of foreign direct investment in Canada in recent years.

A bilateral or trilateral trade agreement could result in some investment diversion to Mexico and the U.S., at Canada's expense. Another possibility, however, is that a North American free trade area will result in higher economic growth and investment creation, to Canada's benefit.

While quantitative models on trade diversion and trade creation have been extensively used in conventional analysis to address the impact of "freer" trade between one or more member countries, investment diversion/creation cannot be analyzed with the same degree of precision. Further research with respect to the pattern of investment creation/diversion in a NAFTA scenario must take into account a host of underlying factors and assumptions. If it is true that the recent explosion in international direct investment is primarily market-driven and guided by globalization motives, then it is reasonable to expect more investment flows into countries which offer the greatest potential in terms of both market size and growth prospects. A NAFTA would strengthen the investment attractiveness of all three parties to the agreement.

Table I-1

Foreign Direct Investment in Mexico

Cumulative Value of FDI in Millions of U.S. Dollars

	1980	1984	1985	1986	1987	1988	1989	Average Annual Growth 1980-85	1985-89	1980-89
U.S.	5,836.6	8,513.4	9,840.2	11,046.6	13,716.2	14,957.8	16,748	11.0	14.2	12.4
% of FDI	69.0	66.0	67.3	64.8	65.5	62.1	63.0			
FRG	676.7	1,125.4	1,180.8	1,399.4	1,446.3	1,583.0	1,675	11.8	9.1	10.6
% of FDI	8.0	8.7	8.1	8.2	6.9	6.6	6.3			
Japan	499.1	816.0	895.3	1,037.5	1,170.3	1,319.1	1,356	12.4	10.9	11.7
% of FDI	5.9	6.3	6.1	6.1	5.6	5.5	5.1			
Switzerland	473.7	647.7	788.9	823.0	918.2	1,004.5	1,170	10.7	10.3	10.6
% of FDI	5.6	5.0	5.4	4.8	4.4	4.2	4.4			
Spain	203.0	369.6	383.6	477.3	603.1	637.2	691	13.6	15.9	14.6
% of FDI	2.4	2.9	2.6	2.8	2.9	2.6	2.6			
U.K.	253.7	395.5	451.9	556.2	987.1	1,754.7	1,781	12.2	40.9	24.2
% of FDI	3.0	3.1	3.1	3.3	4.7	7.3	6.7			
France	101.5	237.3	248.0	564.9	596.1	748.5	798	19.6	33.9	25.7
% of FDI	1.2	1.8	1.7	3.3	2.8	3.1	3.0			
Sweden	126.9	230.4	235.9	260.5	297.2	329.7	346	13.2	10.0	11.8
% of FDI	1.5	1.8	1.6	1.5	1.4	1.3				
Canada	126.9	194.8	229.7	270.3	289.6	323.5	372	12.6	12.8	12.7
% of FDI	1.5	1.5	1.6	1.6	1.4	1.3	1.4			
Netherland	93.0	138.8	161.2	171.4	204.7	272.8	266	11.6	13.3	12.4
% of FDI	1.1	1.1	1.1	1.0	1.0	1.1	1.0			

Table I-1 (continued)

Italy	25.4	33.9	34.5	38.5	41.3	41.3	53	6.3	11.4	8.6
% of FDI	0.3	0.3	0.2	0.2	0.2	0.2	0.2			
Others	42.3	197.1	178.9	404.2	659.9	1,112.0	1,329	33.4	65.1	46.7
% of FDI	0.5	1.5	1.2	2.4	3.2	4.6	5.0			
Total Cumulative FDI	8,458.0	12,899.9	14,628.9	17,043.8	20,927.0	24,084.1	26,584	11.6	16.1	13.6

Source: Executive Secretariat of the National Foreign Investment Commission, Mexico.

Table I-2

Cumulative Flow of Direct Foreign Investment as Measured by the National Foreign Investment Commission (Millions of U.S. Dollars)

Year	New Investment	Percent Change	Cumulative Direct Foreign Investment	Percent Change
1973	287.3	51.3	4,359.5	7.1
1974	362.2	26.1	4,721.7	8.3
1975	295.0	-18.6	5,016.7	6.2
1976	299.1	1.4	5,315.8	6.0
1977	327.1	9.4	5,642.9	6.2
1978	383.3	17.2	6,026.2	6.8
1979	810.0	111.3	6,836.2	13.4
1980	1,622.6	100.3	8,458.8	23.7
1981	1,701.1	4.8	10,159.9	20.1
1982	626.5	-63.2	10,786.4	6.2
1983	683.7	9.1	11,470.1	6.3
1984	1,442.2	110.9	12,899.9	12.5
1985	1,729.0	19,9	14,628.9	13.4
1986	2,431.1	40.6	17,060.0	16.6
1987	3,870.0	59.2	20,930.0	22.7
1988	3,150.0	-18.6	24,084.0	15.1
1989	2,500.0	-20.6	26,584.0	10.4

Table I-3

Major Foreign Investments in Mexico

Name of Enterprise	1987 Rank[1]	Type	Origin of Capital	Percent Foreign Owned
Chrysler de Mexico	2	Automotive	U.S.	99.99
General Motors	3	Automotive	U.S.	100
Ford Motor Company	5	Automotive	U.S.	100
Volkswagen de Mexico	8	Automotive	FRG	100
Celanese Mexicana	10	Artificial fibers	U.S.	40
Kimberly-Clark	12	Paper & Cellulose	U.S.	45
IBM	14	Electronics	U.S.	100
Industrias Resistol	17	Petrochemical	U.S.	39.2
Compania Nestle	13	Food	Swiss	100
American Express	22	Financial Services	U.S.	100
Spicer	29	Autoparts	U.S.	33
Ericcson (Mexico)	33	Electronics	Sweden	73

[1] 500 Largest Enterprises in Mexico 1987, Expansion Magazine, August 17, 1990.

Table I-4

Main Canadian Companies in Mexico

Canadian Investor	Mexican Company	Sector
NEI Canada Ltd	Transformadores Parsons	Industrial
Chempharm Ltd	Farmaceuticos Lakeside, S.A.	Industrial
Diversey Worls Holding Inc	Diversey Mexico, S.A. de C.V.	Industrial
Pharma Investment Ltd	Cafes Industrializados de Veracruz, S.A. de C.V.	Industrial
Cominco Ltd	Minera Maria, S.A. de C.V.	Industrial
Moore Corporation Ltd	Moore Business Forms de Mexico, S.A. de C.V.	Industrial
Canada Wire and Cable International Ltd.	Industrias Axa, S.A.	Services
Philips Trans-America Holdings Corp.	Philips Mexicana, S.A. de C.V.	Industrial
Sapac Corporation Ltd	Roche Mexicana de Farmacos S.A. de C.V.	Industrial
Noranda Inc	Grupo Industrial Premenal, S.A. de C.V.	Industrial

Source: Direcion General de Inversion Extranjera

Table 1-5

Value Added in Maquiladora for Processed Products
(Millions of U.S. Dollars)

	1985	1986	1987	1988
National Total	1,267.2	1,294.5	1,598.1	2,337.4
Foodstuffs processing	10.3	10.9	15.7	23.3
Textiles, apparel	87.2	83.5	101.4	127.7
Shoes, leather goods	20.9	16.8	19.5	28.2
Wooden, matallic furniture and parts	49.9	55.0	78.4	126.5
Chemical products	1.8	4.4	10.0	18.3
Transport equipment	329.5	307.9	381.6	596.3
Equipment and tools, non-electric	20.3	24.9	28.2	37.3
Electrical, electronic machinery, equipment	240.5	269.5	283.4	382.1
Electrical, electronic materials, accessories	328.8	315.1	393.2	585.8
Toys and sporting goods	39.6	40.7	44.3	66.4
Other manufacturing sectors	86.1	117.0	191.5	282.9
Services	52.4	48.8	50.9	62.7

Source: Secretariat of Programming and Budget, Bank of Mexico.

Table II-1
United States Direct Investment Abroad (USDIA)
Canada, Mexico and Other Principal Destinations
(In Million of U.S. Dollars)

	U.S. Direct Investment Position						Average Annual Growth (percent)			Change in Stock
	1980	1985	1986	1987	1988	1989	1980-85	1985-89	1990/89	1990/89
Canada	45,119	46,909	50,629	57,783	62,610	66,856	0.8	9.3	6.8	4,246
% of DIA	20.9	20.4	19.5	18.4	18.8	17.9				10.6
Europe	96,287	105171	120724	150439	156932	176736	1.8	13.9	12.6	19,804
% of DIA	44.7	45.7	46.5	47.9	47.1	47.3				49.6
EC[1]	73,569	81,380	95,629	119428	125590	143360	2.0	15.2	14.1	17,770
% of DIA	34.2	35.3	36.8	38.0	37.7	38.4				44.5
OECD	158214	172058	194280	237508	252757	279310	1.7	12.9	10.5	26,553
% of DIA	73.5	74.7	74.8	75.6	75.8	74.8				66.5
Latin America	18,714	28,261	36,851	47,551	51,041	61,364	8.6	21.4	20.2	10,323
% of DIA	8.7	12.3	14.2	15.1	15.3	16.4				25.8
Mexico	5,986	5,088	4,623	4,913	5,694	7,079	-3.2	8.6	24.3	1,385
% of DIA	2.8	2.2	1.8	1.6	1.7	1.9				3.5
Asia[2]	22,384	35,378	36,144	44,057	49,628	55,827	9.6	12.1	12.5	6,199
% of DIA	10.4	15.4	13.9	14.0	14.9	14.9				15.5
LDCs[3]	53,206	52,764	61,072	73,017	77,560	90,552	-0.2	14.5	16.8	12,992
% of DIA	24.7	22.9	23.5	23.2	23.3	24.2				32.5
Others[4]	32,871	14,531	15,452	14,477	13,290	12,653	-15.1	-3.4	-4.8	-637
% of DIA	15.3	6.3	5.9	4.6	4.0	3.4				-1.6
Total	215375	230250	259800	314307	333501	373436	1.3	12.9	12.0	39,935

Notes:
[1] The 1980 EEC includes 7 countries: Belgium, Luxembourg, France, FRG, Italy, Netherlands, and the U.K. From 1985-1990, the EEC represents 10 member countries with the addition of Denmark, Greece and Ireland.
[2] The Asia-Pacific region includes Australia and Japan.
[3] Developing countries exclude Australia, Japan, and South Africa.
[4] All "Others" include New Zealand, Africa, Middle-East and other direct investment transactions not allocated to any country of destination.

Table II-2
U.S. Direct Investment Abroad: Net Capital Outflows (Inflows [-])
Canada, Mexico and Principal Destinations
(in Millions of U.S. Dollars)

	Capital Outflows					Cumulative Net Flows
	1985	1986	1987	1988	1989	1985-89
Canada	173	2,400	6,200	2,587	1,352	12,712
% of total	1.3	12.8	20.0	16.0	4.3	11.5
Europe	7,592	7,587	12,691	8,464	15,315	51,649
% of total	57.7	40.6	40.9	52.2	48.3	46.6
EC	6,450	6,667	9,581	8,358	13,644	44,700
% of total	49.0	35.7	30.9	51.5	43.0	40.3
Developed	8,548	10,713	21,326	13,189	19,264	73,040
% of total	64.9	57.4	68.7	81.3	60.7	65.9
Latin America	4,210	7,445	8,127	2,705	10,004	32,491
% of total	32.0	39.9	26.2	16.7	31.5	29.3
Mexico	458	-132	328	579	1,360	2,593
% of total	3.5	-0.7	1.1	3.6	4.3	2.3
Asia[1]	1,047	1,821	3,621	3,475	4,804	14,768
% of total	8.0	9.7	11.7	21.4	15.1	13.3
Developing[2]	4,436	8,724	9,942	3,532	12,135	38,769
% of total	33.7	46.7	32.0	21.8	38.3	35.0
All Others[3]	140	-574	406	-1,013	247	-794
% of total	1.1	-3.1	1.3	-6.2	0.8	-0.7
Total Capital Outflows	13,162	18,679	31,045	16,218	31,722	110,826

Source: U.S. Department of Commerce, Survey of Current Business.

NOTES:
[1] The Asia-Pacific region includes Australia and Japan, but excludes the Middle East.
[2] Developinc countries exclude Australia, Japan, and South Africa.
[3] All "Others" include New Zealand, Africa, Middle-East and other direct investment transaction not allocated to any country of destination.

Table II-3
U.S. Direct Investment Position Abroad
Industry Detail for Canad and Mexico, 1984 & 1988
(in Millions of U.S. Dollars)

	Canada		Mexico		All Countries	
	1984	1989	1984	1989	1984	1989
All industries	46,730	66,856	4,597	7,7079	211,480	373,436
Petroleum	11,156	10,912	71	68	58,051	57,495
% of total[1]	23.9	16.3	1.5	1.0	27.4	15.4
Manufacturing of which:	20,986	32,333	3,650	5,837	85,865	115,704
Food products	1,634	2,175	414	466	8,156	15,783
% of total	3.5	3.3	9.0	6.6	3.9	4.2
Chemicals	4,777	6,580	746	1,505	19,200	36,157
% of total	10.2	9.8	16.2	21.3	9.1	9.7
Fabricated Materials	1,672	2,437	332	269	5,256	8,194
% of total	3.6	3.6	7.2	3.8	2.5	2.2
Machinery	2,491	3,316	202	321	14,816	27,137
% of total	5.3	5.0	4.4	4.5	7.0	7.3
Electrical	1,594	2,173	450	451	8,193	11,872
% of total	3.4	3.3	9.8	6.4	3.9	3.2
Transport	4,337	7,673	505	1,518	10,664	23,480
% of total	9.3	11.5	11.0	21.4	5.0	6.3
Other	4,480	7,970	1,001	1,308	19,581	33,081
% of total	9.6	11.9	21.8	18.5	9.3	8.9

Table II-3 (continued)

Wholesale trade	2,439	3,917	443	395	21,117	37,735
% of total	5.2	5.9	9.6	5.6	10.0	10..1
Banking	521	945	-3	0	13,516	19,875
% of total	1.1	1.4	-0.1	0.0	6.4	5.3
Insurance	6,139	11,680	195	130	15,683	77,112
% of total	13.1	17.5	4.2	1.8	7.4	20.6
Services	705	1,385	-26	138	4,447	8,812
% of total	1.5	2.1	-0.6	1.9	2.1	2.4
Other	4,785	5,684	268	0	12,799	16,253
% of total	10.2	8.5	5.8	0.0	6.1	4.4

Source: U.S. Department of Commerce, Survey of Current Business, August 1989.
NOTE: [1] "% of total" indicates sector as a percentage of total U.S. Direct Investment in the country.

Section B: The Regulation of Foreign Investment In Mexico

Mexico has exhibited a long history of economic nationalism, a policy based upon its distrust and resentment first of European, and then of US, economic colonization of the country. As a result, for the past 70 years Mexico has enforced laws restricting foreign investment. Since the mid 1970's, the framework and climate for foreign investment was set by three laws designed to Mexicanize the economy by stimulating domestic private investment and restricting foreign investment: the 1973 Law for the Promotion of Mexican Investment and the Regulation of Foreign Investment; the 1973 Technology Transfer Law (revised January ll, 1982); and the 1976 Law on Patents and Trademarks (modified in 1986).

Since 1986, however, under the direction of President Miguel de la Madrid Hurtado and, more particularly, under his successor Carlos Salinas de Gortari, Mexico has undergone a dramatic change with respect to its economic policies. The new policy direction involves nothing less than a fundamental restructuring of the Mexican economy and a sweeping change with respect to attitudes toward foreign investment.

The following material reviews the important changes which have been made since 1988 in the laws regulating foreign investment in Mexico. An understanding of current regulations is highly pertinent since a key U.S. and possibly Canadian objective in free trade negotiations with Mexico is to secure the progress made in trade and investment liberalization to date. An international accord would better ensure that future governments in Mexico would adhere to the trade and investment liberalization already established by Salinas.

Investment Canada's assessment of Mexico's investment regulations is based upon documentation provided by Mexican officials and other written material. A full appreciation of Mexico's foreign investment policy and regulatory process will require further research. It is clear that some degree of discretion remains in the interpretation and application of the Mexican investment regime. Under the circumstances, a judgement of the actual liberalization achieved or intended by the Mexican government must await actual future developments with respect to specific instances of foreign direct investment.

Law For The Promotion Of Mexican Investment And The Regulation Of Foreign Investment

Former Foreign Investment Restrictions

The 1973 Law on Foreign Investment limited foreigners to minority ownership. Foreigners could not acquire more than 25 per cent of the shares or 49 per cent of the fixed assets of any Mexican company without prior authorization from the National Commission on Foreign Investment (NCFI), a semi-autonomous agency within the Ministry of Commerce and Industrial Development. Authorization of ownership in excess of these levels was approved or rejected based on the NCFI's judgement as to whether a higher level of foreign investment would be beneficial to the economy. Seventeen criteria, or General Resolutions, were considered in making such a decision. Permission for foreign ownership in excess of the regulatory levels was given increasingly frequently, especially in later years and particularly in industries regulated under Sector Development Programs. However, decisions reportedly took from 8 up to 16 months and were made on a fairly discretionary basis. Foreign investors lacked clear, neutral and fixed guidelines. Prior approval was also required by foreign investors for all increases in existing investment, including the undertaking of new activities, the introduction of new product lines, as well as for expansions and for relocations.

Regulations of the Law to Promote Mexican Investment and to Regulate Foreign Investment, May 16, 1989

In May 1989, the Mexican Government announced a comprehensive reform of the law regulating foreign investment. The changes provided clear-cut and neutral regulations governing foreign direct investment, facilitated procedures for making new foreign investments, and opened many new areas for majority foreign ownership. The changes have been made with the specific intent of attracting foreign investment, which the Salinas government recognizes as essential in achieving the economic growth required to complete the transformation of Mexico into a modern, industrial economy. Provisions of the revised regulations are detailed below.

Legal status. The new regulations, which were implemented through presidential decree, modify the 1973 law, which remains the fundamental legal framework governing foreign investment in Mexico.

Invariable guidelines. The revised rules provide a precise, neutral and standard framework for all investment projects. Case by case authorizations will now be limited to exceptional instances.

Administrative time limit. The NCFI must act on a foreign application within 45 working days of its receipt. If no response is given within that period, the application is deemed automatically approved.

Registration of foreign companies. As previously, all corporations wholly or partially owned by foreign investors must register with the National Registry of Foreign Investments a sub-unit also of the Ministry of Commerce and Industrial Development. Foreign firms must also obtain a permit from the Secretariat of Foreign Affairs to authorize the acquisition of property; this step is routine once approval (automatic or processed) of the investment has been granted by the NCFI.

Expanded foreign majority ownership possibilities. The regulations now permit foreign investors to form new Mexican corporations, with up to 100 per cent ownership, in "unclassified" activities accounting for approximately two thirds of Mexican gross domestic product. Furthermore there has been a radical broadening of the range of economic sectors open to wholly-owned foreign investment. Now included in the "unclassified" sector are the previously restricted glass, cement, iron, steel and cellulose industries. Of the remaining 141 classified activities, 58 more are open to 100 per cent foreign investment with prior NCFI approval. In addition majority foreign ownership in other classified activities is possible through the medium of a temporary, 20-year trust mechanism.

Automatic approval of foreign majority ownership in unclassified activities. Authorization of up to 100 per cent foreign ownership is automatic upon registration of that investment with the National Commission on Foreign Investment, where the following conditions are satisfied:

- the investment is made in an "unclassified activity";
- the investment does not exceed $100 million;
- financing, either debt or equity, is accomplished with foreign-sourced funds. Foreign investors already established in Mexico may use funds they already possess in Mexico. At the end of the pre-operating stage, shareholders' equity must be equal to a minimum of 20 per cent of the investment in fixed assets;
- the investment is located someplace other than in the highly populated areas of Mexico City, Monterrey, Guadalajara or certain municipalities of the states of Hidalgo and Mexico; this provision applies only to industrial projects;
- the company maintains, on a cumulative basis, a favourable balance of foreign exchange during the first three years of operation;
- the investment creates permanent employment for Mexican workers and provides continuing training and educational programs to upgrade employee skills;
- the investment incorporates technology that satisfies existing environmental requirements.

Restrictions on Foreign Ownership. Restrictions on foreign investment apply in the case of 141 activities. These activities are listed in the "Classification" which forms part of the May 1989 Regulations to the Foreign Investment Law. The classification is subdivided into six categories (see Annex B-1 for details):

Category 1	Activities reserved exclusively to the state (12 activities)
Category 2	Activities reserved to Mexican nationals (34 activities)
Category 3	Activities that allow up to 34% foreign ownership (4 activities)
Category 4	Activities that allow up to 40% foreign ownership (8 activities)
Category 5	Activities that allow up to 49% foreign ownership (25 activities)
Category 6	Activities that require prior authorization for majority foreign ownership (58 activities).

Even though certain sectors remain restricted, noteworthy liberalization has taken place within sectors.

- In the telecommunications sector (formerly reserved exclusively to the state), foreign investment is now allowed up to 49 per cent.

- In the petrochemical sector, fourteen petrochemicals have been reclassified from "basic" (reserved exclusively to the state) to "secondary"; 539 petrochemicals have been reclassified from "secondary" (minority foreign participation permitted) to "tertiary" (open to 100 per cent foreign participation).

- In the insurance industry the permissible level of foreign investment has been raised from 15 to 49 per cent. (See section on The Regulation of Foreign Investment in the Insurance Industry.)

- Banking, although remaining closed to foreign control, will now apparently be open to foreign participation up to a maximum of 30 per cent. (See Section on The Regulation of Foreign Investment in Banking.)

Establishment of new firms, with foreign participation in excess of 49 per cent, in certain classified activities. Foreign investment of up to 100 per cent may be permitted by prior authorization of the NCFI in Category 6 activities if the NCFI is satisfied that the investment will satisfy the following criteria:

- serve as a complement, not as a replacement, to domestic investment;
- promote exports and contribute positively to the balance of payments;
- create jobs and improve the remuneration of employees;
- contribute to the development of less economically developed regions;
- bring in technology and/or undertake R&D in Mexico.

Acquisition of existing corporations. Under the 1973 law, acquisition by foreigners of more than 25 per cent of the shares or 49 per cent of the fixed assets of any existing enterprise required authorization by the NCFI. As a result of the 1989 revisions, during a three year period ending on May 16, 1992, foreign investors may now - without prior authorization - acquire up to 100 per cent of the stock of existing corporations engaged in an unrestricted activity. The acquiring firm must undertake to satisfy the criteria for automatic approval of foreign investment in an unclassified activity and to invest in additional fixed assets an amount equal to at least 30 per cent of the acquired firm's current fixed assets.

Expansion of existing foreign investment. Under the 1973 law, prior authorization was required for relocation, expansion, new product lines and the undertaking of new activities. Under the 1989 revisions, these activities may be undertaken without prior authorization, where an enterprise undertakes to invest in additional fixed assets an amount equal to at least 10 per cent of the net value of its current fixed assets and to meet the requirements for new foreign investment in unclassified activities.

Temporary foreign majority ownership in certain classified activities. Foreign investors may now, through participation in special trust mechanisms, acquire temporary majority ownership in any of the classified activities that are subject to specific percentage limitations for foreign investment. Included under this provision are the important sectors of gas distribution and domestic air and maritime transportation (normally reserved for Mexican nationals); mining, secondary petrochemicals, automotive parts, fishing, and financial leasing (normally restricted to a maximum foreign ownership of 34 or 49 per cent). Trusts may be established for up to a 20-year period. In the case of majority ownership through trusts, the following conditions must apply: the company acquired is experiencing financial difficulties and/or has large foreign currency liabilities; the acquired company needs new capital to finance investment designed to upgrade technology, modernize operations, increase production, manufacture new products or increase exports; no interested Mexican investors could be identified; Mexican investors have waived any existing preferential stock acquisition rights; the foreign investment will be in the form of cash or a capitalization of the company's liabilities.

Special trusts also permit foreign investors to acquire temporary control over restricted coastal and border zone real estate. Under the 1973 Foreign Investment Law, real estate trusts of up to 30 years could be established. Under the 1989 revisions to the law, trusts can now be renewed for an additional 30 years, thereby enabling foreigners to fully realize long-term investment projects. In a trust mechanism, ownership of property is vested in the trustee (usually a Mexican bank) but all other proprietary rights are exercised by the investor, including the right to build on the land, sell the rights to others, or order transfer of the title to a qualified Mexican owner. Real estate trusts may be established for either industrial or tourism purposes.

Investment in Mexico's stock exchange. The May 1989 regulations allow foreigners to undertake portfolio investment in Mexican equities through the medium of special 30-year trust funds. These trust funds are empowered to acquire and hold specially designated "N" or neutral shares of Mexican corporations and to pass on to foreign investors the economic rights to such shares through the sale of trust "participation certificates".

Technology Transfer Law

Technology Transfer Law, 1973 (revised Jan. 11, 1982). In 1973, the Mexican government passed a law governing technology transfer. The intent of the 1973 law was to establish ground rules that would secure better treatment for Mexican firms in contracts for technology with frequently more powerful foreign firms. To this end, the 1973 law established a National Registry of Technology to review and approve all royalty and licensing agreements. The Registry enjoyed discretionary powers and, although in recent years it permitted more generous contract terms, it enforced fairly restrictive terms through the greater part of the 1973-mid-1980s period. In so doing, the law created a climate which discouraged foreign technology transfer. Advanced technology was withheld from the country, one factor leading to today's problem of inefficient, non-competitive industries.

Revision of the Technology Transfer Law, January 1990. The Mexican Government has undertaken the process of reforming its rules on technology transfer and intellectual property. In January 1990, it promulgated important changes to the existing technology transfer law. The changes provide for greater contract flexibility, greater confidentiality, a simplified administrative and reporting process, and some added protection against piracy for licensors of technology. Specifically, the January 1990 changes have the following effects:

- **term of contract:** technology transfer contracts were formerly limited to 10 years. Under the new rules, terms are no longer regulated.

- **royalties:** the earlier law contained no reference to any specific rate on royalties, license fees or other charges. However the National Registry limited royalties to 3% for some time, although royalties of 5 - 7% were approved in more recent years. Under the January 1990 revisions, royalties can now be freely negotiated.

- **approval process:** formerly lengthy and complicated. Now contracts are virtually automatically approved upon registration. This removes from authorities the power to require supplementary undertakings, a practice which was fairly common.

- **confidentiality:** contract provisions granting protection to licensors against unauthorized use of their technology by licensees can now be extended beyond the contract's expiration date. This possibility applies as long as the original technology was upgraded during the term of the original contract.

- **franchises:** franchise procedures and requirements are established in an effort to encourage investment under this form.

- **exports:** export requirements or limitations were often applied on a case by case basis. Now uniform regulations are clearly defined in the new law.

These revisions represent great improvements to the old law. Despite the many improvements, however, important gaps remain. The revised technology transfer law provides improved protection to licensors against infringements by licensees (confidentiality provision extension) but it does not protect against violations by third parties. This latter problem remains to be addressed by new legislation which the government plans to bring forward in the area of patents, trademarks and trade secrets.

Patent And Trademark Law

Further improvement in this area remains a priority of the United States in its bilateral agenda with Mexico.

In January 1990 the Mexican Government announced it was drafting new legislation, to be sent for approval to Congress around the end of 1990, to provide for intellectual property protection "similar to that which is given in advanced nations". Given the necessary legislative process, it may take longer to accomplish these desired changes than was necessary in the instances of the laws on technology transfer and on foreign investment regulation. Changes to those two laws were made by presidential decree thanks to clauses in both laws giving the government discretionary powers to interpret and change those regulations.

Required improvements to the patent and trademark law include, first and foremost: extension of patent terms; extension of patent protection to products in such sectors as chemicals, pharmaceuticals and biotechnology; and further improvements in trade secret protection.

Nonetheless, on the basis of the Salinas government's clear intention to address these issues and the improvements already introduced to the Technology Transfer Law, the United States has removed Mexico from the US Special 301 "Priority Watch List" of nations lacking adequate intellectual property protection.

Regulation of Foreign Investment in the Banking Sector

In July 1990, the new Law on Credit Institutions came into effect, re-establishing the framework for private ownership of commercial banks in Mexico. This law provides for the issue of three categories of common stock. The third category, "C" shares, may be purchased by foreigners. The issue of C shares is subject to approval by the Ministry of Finance and Public Credit. C shares, if issued, can equal up to 30 percent of bank capital.

With respect to individual participation, the law restricts any individual or entity, Mexican or foreign, to share holdings equivalent to no more than five per cent (10 per cent in exceptional cases authorized by the Ministry of Finance and Public Credit) of the capital stock of a commercial bank.

Foreign banks may now also hold a minority stake in holding companies of financial groups.

Regulation of Foreign Investment in the Insurance Industry

New investment by foreign corporations in the insurance sector had been prohibited since 1935. Foreign companies already established in the sector at that time were allowed to remain but were required to reduce their participation to below 50 per cent; that level was later reduced to 15 per cent. Reforms announced in January 1990 remove the ban on new foreign corporate investment and raise the allowable level of foreign participation to 49 per cent.

Law Regarding Maquiladoras

The maquiladora, or in-bond industry, is the most rapidly growing sector of the Mexican economy. Originally established in 1965 by agreement between the US and Mexican Governments, the program first started to come into its own during the mid-1970s, when increased competition from Asian countries forced US manufacturers to seek methods of lowering production costs. The 1984 peso devaluation gave a further boost to the program but the phenomenal expansion of this sector coincides with the implementation of the current economic reforms which began in 1985. Growth in value-added soared to 24 per cent in 1987 and to 46 and 30 per cent in 1988 and 1989. At the end of 1989, there were 1,800 maquiladora plants employing an estimated 500,000 Mexican workers. These plants produced an estimated US $13 billion in products, almost exclusively for export to the US market. In 1989 this production created an estimated US $3 billion in value-added income for Mexico. After the petroleum industry, the maquiladora sector is Mexico's largest producer of foreign exchange.

Under the maquiladora program, foreign corporations can establish wholly-

owned Mexican subsidiaries which operate under special customs treatment. The firms are allowed to import - duty-free and on a temporary "in bond" basis - machinery, equipment, parts, raw materials and other components used in the assembly or manufacture of semi-finished or finished products. The maquiladoras import semi-finished products from the US for assembly or further manufacture in Mexico. Under US tariff items 806.30 and 807.00, these products are then allowed to re-enter the US market with duty levied only on components that are not of US origin and on the "value added" during assembly or manufacture in Mexico.

Currently 60 per cent of existing maquiladoras are owned by US firms. However the maquiladora scheme is proving increasingly attractive to firms from other countries. Japan, West Germany, Canada, France, Sweden, South Korea, Hong Kong and Taiwan have all moved funds into Mexican maquiladora investments more recently.

Since 1983 certain industrial sectors have seen particularly strong expansion in the number of maquiladora factories: automotive accessories (+ 290%), electrical and electronics industries (+ 51%), and metal products (+ 44%). Based on the amount of value-added in 1988, the following were the most important sectors: electric and electronic goods (41%), transport equipment (26%), and textiles and apparel (6%).

The Mexican government is eager to encourage further investment of this nature. Regulations governing the maquiladora industry, already very liberal, were liberalized further by the government in December 1989. Major provisions regarding investment in this sector are as follows:

- 100 per cent foreign ownership is permitted
- investments may be made in any amount
- approval for foreign investment is automatic and can be obtained in 3 working days from the Ministry of Commerce & Industrial Development (SECOFI)
- administrative procedures necessary to establish or expand a firm are now the sole responsibility of SECOFI; six different departments were formerly involved
- maquiladoras now receive automatic authorization to locate plants in any area zoned for industrial development. Originally plants were restricted to an area close to the US-Mexican border. Since 1972, plants have been allowed to locate elsewhere and firms are showing an increasing preference for interior, one-company-town sites, as labour behaviour in northern border plants is becoming increasingly unruly. As of 1988, 18 percent of maquiladora plants were located in interior areas and that number is increasing.
- maquiladora licenses now carry open-ended terms; in-bond firms formerly had to seek pro-forma renewal of licenses every two years.
- under certain conditions, an in-bond firm may now sell locally an amount equal to 50 per cent of additional value above their annual exports sales. Initially the entire output of a maquiladora had to be exported. In 1983, regulations were relaxed to allow domestic sales equal to 20% of additional value above the

previous year's exports.

- technology transfer is encouraged by: 1) allowing the in-bond importation of computers and telecommunications equipment for administrative purposes; and 2) authorizing maquiladoras, under certain conditions, to transfer machinery, tools and equipment to another maquiladora or to their domestic suppliers.
- under the new rules, Mexican companies which supply inputs to the maquiladoras are excused from paying value-added tax on the inputs supplied, reducing the price of their products by as much as 15 percent.
- maquiladoras may now enter into subcontracting agreements with domestic firms (further integrating maquiladoras into the Mexican economy).

ANNEX B-I

CLASSIFICATION OF ECONOMIC ACTIVITIES WITH RESPECT TO FOREIGN INVESTMENT LIMITS

The following classification of activities was published as part of the May 1989 Regulations of the Law to Promote Mexican Investment and to Regulate Foreign Investment. The classification defines the activities in which foreign investment is not permitted, is limited, or requires authorization to exceed 49% ownership. The law establishes the following six categories:

Category	Restriction
1.....	Activities reserved exclusively to the state.
2.....	Activities reserved to Mexican nationals.
3.....	Activities in which foreign participation is permitted up to 34% of the company's capital.
4.....	Activities in which foreign participation is permitted up to 40% of the company's capital
5.....	Activities in which foreign participation is permitted up to 49% of the company's capital.
6.....	Activities where majority foreign participation is possible with prior authorization from the National Commission on Foreign Investment.

Any activity not included in the classification is open to 100% foreign participation without prior authorization, provided certain requirements described in the regulations are met. The activities in Categories 5 and 6 are not required to secure prior authorization nor to meet these additional requirements if foreign investment does not exceed 49%.

Category 1 - Activities reserved exclusively to the state

Oil and gas production
Mining and/or refining of uranium and radioactive minerals
Manufacture of basic petrochemical products
Oil refining
Treatment of uranium and nuclear fuels
Coin minting
Generation and transmission of electric energy
Supply of electric energy
Railroad transportation services
Telegraph services
Banking services
Financial trusts and funds

Category 2 - Activities reserved to Mexican nationals
Forestry
Forest nursery business
Retailing of liquified gas
Building materials transportation services
Moving services by road
Other specialized cargo transportation services by road
General cargo transportation services by road
Bus transportation services (intercity)
Urban and suburban bus transportation services
Taxis
Fixed route taxi services
Taxi stand services
School and tourism bus services
Coastal transportation
Coastal and high seas towing
Passenger air transportation in aircraft with Mexican registry
Air taxi transportation
Credit unions
Public warehouses
Foreign exchange houses
Financial consulting and promotion
Nonbanking savings and loans institutions
Other credit institutions
Brokerage firms
Investment companies (1)
Stock market services
Bonding
Insurance
Independent pension fund management
Private transmission of radio programs
Transmission and repetition of television programs
Notary public services (2)
Customs brokers and representative services (2)
Management of sea, lake and river ports

Notes:

(1) **Fixed-income investment companies and their management companies are not eligible for investment by foreign governments or their agencies, foreign financial entities, or other associations of foreign persons, whether individual or juridical.**

(2) **Companies may have a foreign investment participation to the extent authorized by the National Commission for Foreign Investment. Providers of professional services are subject to the Regulatory Law of the Third Constitutional Article, pertaining to professional practices, and should be Mexican nationals.**

Category 3 - Activities that allow up to 34% foreign ownership

Mining and refining of coal
Mining and/or refining of iron ore
Mining and/or refining of phosphoric rock
Mining of sulphur

Category 4 - Activities that allow up to 40% foreign ownership

Manufacture of secondary petrochemical products
Manufacture of parts and accessories for automotive electrical systems
Manufacture and assembly of bodies and trailers for automobiles and trucks
Manufacture of automobile and truck motors and their parts
Manufacture of automobile and truck transmission parts
Manufacture of automobile and truck suspension system parts
Manufacture of parts and accessories for automobile and truck brake systems
Manufacture of other parts and accessories for automobiles and trucks

Category 5 - Activities that allow up to 49% foreign ownership

Deep water fishing*
Shallow water fishing*
Fresh water fishing*
Artificial fish breeding*
Mining and/or refining of minerals containing gold, silver and other precious minerals and metals
Mining and/or refining of mercury and antimony
Mining and/or refining of industrial minerals with lead and zinc content
Mining and/or refining of minerals containing copper
Mining and/or refining of other nonferrous metallic minerals
Mining and/or refining of feldspar
Mining of gypsum
Mining and/or refining of barite
Mining and/or refining of fluorite
Mining of other minerals to obtain chemical products
Mining and/or refining of salt
Mining and/or refining of graphite
Mining and/or refining of other nonmetallic minerals
Manufacture of explosives and fireworks
Manufacture of firearms and cartridges

Retailing of firearms, cartridges and ammunition
River and lake transportation
Harbor transportation services
Telephone services
Other telecommunications services
Financial leasing

***Note: Does not include exploitation of species reserved for fishing cooperatives.**

Category 6 - Activities that require prior authorization if a majority foreign ownership is desired

Agriculture
Stock breeding and hunting
Gathering of forestry products
Timber
Newspaper and magazine publishing (1)
Manufacturing of coke and other coal products (2)
Residential or housing construction
Nonresidential construction
Construction of urban works
Construction of industrial plants
Construction of power generating plants
Construction and laying of power transmission networks and lines
Construction of oil and oil by-products pipelines
Concrete structure erection or installation
Steel structure erection or installation
Ocean and river works
Construction of streets and highways
Construction of railroad tracks
Hydraulic and sanitary systems for buildings
Electric systems for buildings
Telecommunications installations
Other special installations
Earth moving
Foundations
Excavations
Underwater works
Installation of traffic and protection signals
Demolitions
Construction of water treatment plants
Drilling of oil and gas wells
Drilling of water wells
Other construction works

High seas transportation
Tourism ship chartering
Investment Companies (3)
Management companies of investment companies (3)
Private pre-school or kindergarten services
Private elementary school services
Private junior high school services
Private high school services
Private university services
Private educations services that combine kindergarten, elementary, high school, college, and university
Private commercial and language school services
Private technical, and handicrafts training school services
Private music, dance and other school services
Private special education school services
Legal Services (4)
Accounting and auditing services (4)
Management of passenger bus terminals and auxiliary services
Management of toll highways, international bridges and auxiliary services
Towing of vehicles
Other ground transportation services
Air navigation support services
Management of airports and heliports
Securities and investment consulting services
Insurance and bonding agency services
Pension consulting services
Representatives of foreign financial entities services
Other services related to financial, insurance and bonding institutions

Notes:

(1) **Does not include printing of bank notes and postage stamps, activities that are reserved to the state.**

(2) **Does not include the production of oil, an activity that is reserved to the state.**

(3) **Fixed-income investment companies and their management companies are not eligible for investment by foreign governments or their agencies, foreign financial entities or other associations of foreign persons, whether individual or juridical.**

(4) **Companies may have a foreign investment participation to the extent authorized by the National Commission for Foreign Investment. The providers of professional services are subject to the Regulatory Law of the Third Constitutional Article pertaining to professional practices and should be Mexican nationals.**